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farrelly's

SPOTLIGHT on INFLATION

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farrelly’s Spotlight on inflation

Executive summary

Investment markets fear long-term persistent inflation

Long-term inflation causes interest rates to rise and sharemarkets and commercial property markets to fall. To make matters worse, the real value of a dollar is falling as well. Persistent high inflation is something that is unambiguously bad for investors.

Consumer price inflation not asset price inflation

We are only concerned with Consumer Price Inflation (CPI) in this note and, in particular, persistently high inflation as short bursts of inflation do little damage to investors. On the other hand, we are not at all concerned about asset price inflation. This is when shares and property prices rise and is unambiguously good for investors.

If inflation becomes persistent, Central Banks will almost certainly lift interest rates

Central Banks, such as the Reserve Bank of Australia (RBA), have two main jobs; maintaining full employment and keeping inflation under control. If unemployment is rising they tend to reduce interest rates to encourage spending by companies and households. If inflation appears to becoming persistent, they will lift interest rates to slow consumption. They take this responsibility very seriously and will almost certainly lift interest rates, perhaps sharply, if they deem it necessary.

Cash rates at 3% will kill inflation - and the economy

Due to the very high level of household mortgage debt in Australia and NZ, it won’t take much of an interest rate hike to subdue the economy. A 1% hike will cause noticeable pain to household budgets. A 3% hike in rates will most likely cause a recession - and kill inflation at the same time. The RBA has all the tools it needs to control inflation.

The current elevated levels of inflation are caused by shortages, Central Banks are right to do nothing - for now

There are different causes of inflation which attract different Central Bank responses. The current inflation spike is caused by shortages. Higher prices help resolve short term shortages; they discourage consumption and encourage production of goods and services. The RBA Is right not to get in the way of markets resolving shortages. However, if inflation looks as it will become more persistent, Central Banks will, rightly, react strongly.

The short-term is tricky, but the longer-term is much more benign

All of which is tricky for short-term investors. How long will this inflation spike persist? How seriously will Central Banks have to slam on the brakes? For investors with a longer-term perspective there is much less to worry about other than the normal bumps along the way. Central Banks will not simply not allow a return to 70’s style inflation.

Inflation

The hottest investment topic of the day is inflation and its possible impact on markets. In farrelly's view it is a storm in a teacup. This sanguine view is very much an outworking of our core philosophy that the long-term is much easier to forecast than the short-term. If we were trying to predict what the next two to three years will look like we would have a much more difficult task - and one with a significant chance of arriving at a seriously wrong answer! By taking a five to ten year view we only need to answer one question - will Central Banks take their inflation fighting mandate seriously? farrelly's believes they will and so, with our longer term perspective, we can be confident that inflation will be brought to heel. This long-term approach vastly simplifies our decision making.

For those who insist on making investment decisions based on a reading of the way the next few years may unfold, we wish you luck.

Investment markets fear persistent inflation

Long-term persistent inflation results in Central Bankers, such as the RBA, increasing interest rates. Rising interest rates cause shares to appear less attractive than fixed interest investments resulting in sharemarket falls. Today, companies typically trade at 20 times the value of their profits. Back in 1989, when inflation was running at 10% per annum or more, that multiple was more like 10 times profits. A return to high inflation could see share prices halve - if profits were maintained. But high inflation and high interest rates hurt profits as well - consumers spend less and higher corporate interest expenses can be a significant drag on profits. With good reason, sharemarkets hate high interest rates and inflation rates.

Similarly, a commercial property today would trade at around 20 times rents whereas, in 1989, that multiple was closer to 10 times rents. And if inflation did re-emerge and the property was geared, any increase in rents due to inflation would be swamped by increases in borrowing costs. Disaster.

To make matters worse, not only would asset prices and cash flows fall in nominal terms, the damage in after-inflation terms is that much more severe again. A return to persistent high inflation would be something that is unambiguously bad for investors.

Consumer price inflation not asset price inflation

We often hear that all the activities of governments and Central Banks have resulted in asset price inflation not CPI inflation. farrelly's has little time for these arguments. As investors, we love asset price inflation - rising share prices and property prices. It is CPI inflation we fear because it is CPI inflation that causes Central Banks to lift interest rates.

For most Central Banks, asset price inflation is of little concern as it is not part of their mandate. In Australia, the issue of rising residential property prices is one for the government and for APRA, the regulator that oversees the stability of the Banking system. The RBA explicitly excludes residential property price inflation from its decision-making. In this note, inflation always refers to CPI inflation.

If inflation becomes persistent, Central Banks will almost certainly lift interest rates

Central Banks, such as the RBA, have two main jobs; maintaining full employment and moderating inflation. They have just one main lever to pull - increasing or decreasing short -term cash rates. In many ways it is the least complicated job in the world.

The idea is that if inflation is rising, the Central Bank increases interest rates which reduces household spending power - particularly in Australia and New Zealand where households have some of the highest levels of mortgage debt in the world. Higher interest rates also cause companies to tighten their belts - less disposable income in households means lower corporate sales and higher borrowing rates tends to discourage corporate investment. All of which slows the economy reducing the demand for goods and services which, in turn, reduces inflationary pressure.

When unemployment is too high, cutting interest rates works in reverse; lower rates increases household income, company sales and investment. All of which encourages growth in the economy getting people back to work. Central Banks take their responsibilities very seriously - not least of which because they have a very simple job and nowhere to hide if inflation takes off. No Central Banker wishes to be remembered as the one who let the inflationary genie out of the bottle. In fact, Paul Volker, who famously lifted interest rates above 20% in the late 70's to crush inflation - and the US economy - is revered in Central Banking circles around the world.

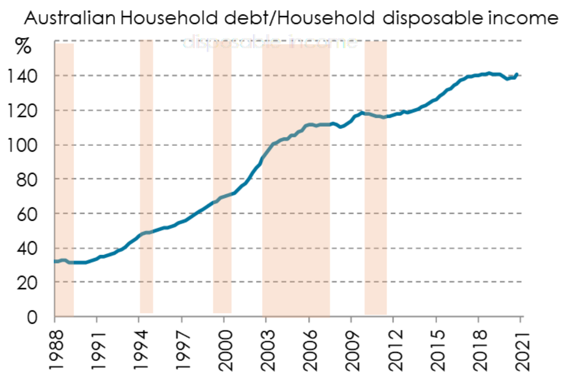
We are very confident that the RBA will lift interest rates when they deem it necessary. Even if it has dire short-term impacts on the economy.

Cash rates at 3% will kill inflation - and the economy

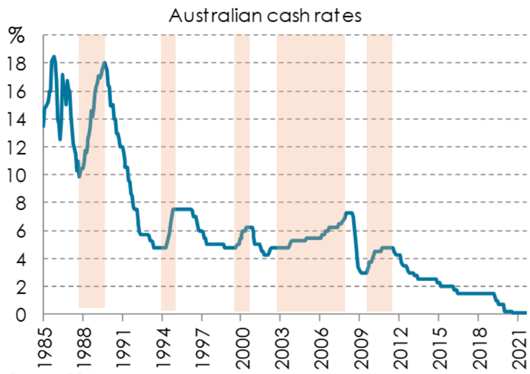
One fear that many commentators voice is that the RBA has lost control because inflation has been below their target range for many years and that low interest rates have lost their power to stimulate the economy. This may indeed be true but when we worry about inflation, we need to ask whether higher rates can slow inflation?

The answer is almost certainly yes. The key, for Australia, is the huge increase in household debt shown in Figure 1 below, which makes the economy highly sensitive to rising rates.

Figure 1: Australian household debt and cash rates



Source: RBA



Source:RBA

Household debt is around 140% of disposable household income today compared to 30% in 1989 when Australian cash rates were at 18%. In other words, if household income was $100,000, household debt would have been on average, $30,000 in 1989 and $140,000 today. Clearly, these are averages, some households would have higher debt, some less but nonetheless, across the economy, the impact on household finances of a 1% increase in interest rates is around five times as large as it would have been in 1989. That is, an increase in cash rates of 2% today would cause the same amount of pain at the household level of a 10% increase in cash rates in 1989.

Of course not all households have mortgage debt. Retirees, for example, tend to have more cash than debt - for them rising interest rates are good for cash flow. However, for the economy as a whole, the total household debt is much larger than household cash holdings and so rising rates are a drag on the economy as a whole.

We see this in Figure 1 where the size of the cash rate increases that the RBA has needed to put in place to slow the economy (the shaded areas of the Figure 1) have got smaller and smaller as household debt levels have increased.

Comparing like with like would suggest that a 2% cash rate increase today would have a major impact on Australian economic growth whereas a 3% increase in cash rates would most likely have the country in a recession. Furthermore, this situation is likely to persist until that mortgage debt is substantially repaid - which will take decades. We are indeed in a long-term low rate interest rate environment.

What should the Central Banks be doing?

Earlier we described the role of the Central Bank to control inflation by varying interest rates. While that is true, what they do will depend on the type of inflation. For the purposes of this note we describe the three main causes of inflation as shortages of goods and services, uncontrolled money printing, and inflation itself. Central Banks should, and do, react differently to each.

When we have **shortages of goods and services** – the main driver of the current burst of inflation - Central Banks, correctly, do very little. Higher prices are the way the product markets adjust to shortages; higher prices increase supply and reduce demand. This is good inflation and the last thing that Central Banks should do is to try and interfere with these market forces.

Wild money printing by governments, such as was seen in Germany in the 1920's and in Zimbabwe from 2001 to 2008, is a second primary cause of inflation. Central Banks are largely powerless to stop this. They could try to increase interest rates – but this is equivalent to a driver pushing the accelerator and the brake to the floor at the same time. Ultimately it just doesn't help.

Fortunately, we see very little evidence of wild money printing today despite comments about Quantitative Easing (QE) money printing and huge government deficits. QE is when the Central Bank buys government bonds. This is not money creation as it is investors essentially swapping their long term bonds for cash - no one gets richer and so this is not inflationary.

On the other hand, government deficits are money creation and are therefore inflationary. However, while large, current deficits are not even close to the level required to cause runaway inflation. We estimate that in order to produce 10% inflation, government deficit spending would need to be of the order of 50% of GDP; much, much larger even than recent deficits. The evidence from Japan supports these contentions. Japan has been running high deficits and Quantitative Easing since 2000 without any sign of inflation.

The final cause of inflation is inflation itself. When prices go up, workers demand higher wages, which employers pass on as higher prices, which, in turn, results in more inflation and another round of wage claims. The infamous wage price spiral. This is where the Central Banks SHOULD step in and increase interest rates. The idea is that by slowing the economy, workers lose their bargaining power, wage increases cease and the spiral is broken.

Right now, we are in the shortage of goods phase and Central Banks are doing absolutely the right thing - nothing. They are letting the markets do their job. However, if inflation persists and starts becoming embedded in the system creating the risk of a wage price spiral, then we will see the Central Banks bring out the heavy artillery and sharply increase interest rates. They have more than enough firepower to bring inflation to heel.

The short-term is tricky. The longer term scenario is more benign

If the Central Banks are right and that this inflation spike is just that, we should see a long gradual increase in cash rates - probably settling at around 1.5% to 2.2%. On the other hand, if inflation proves to be more persistent, Central Banks may need to increase rates, sharply slowing the economy and perhaps even triggering a recession. The latter would be tough for markets in the short-term but good for the economy and business in the longer term. Of course, if this occurs the RBA will be widely criticised for going too late - who would want to be a Central Banker?

In any event, after any rate rise does its work, inflation will be brought to heel, cash rates can then be eased and the recovery will begin - in a low inflation environment.

Whether the bridge to the other side of this current burst of inflation is via a hard landing or a soft landing is really difficult to pick. We suggest investors simply avoid this question because, as usual, the long term outlook is pretty clear - inflation is likely to be modest, eventually. And that is a benign environment for long-term investors.

Unknown unknowns are always the biggest risk we face

An ongoing theme of farrelly's is that known risks should provide few fears for investors. Typically, once risks are well known, financial markets assume the worst and prices fall as if the feared event has actually occurred. If the worst case fears do not eventuate, markets recover rapidly and good returns are made. As Baron Rothschild famously remarked in the 18th century, "Buy when there is blood in the streets."

We saw this writ large in March 2020 when the market panicked at the prospect of the damage COVID would wreak on world economies. At the time we wrote that even our worst case scenarios yielded half decent long term returns. It was a time to be buying not selling.

We see this again today in the bond markets. Fears of inflation and higher interest rates sent Australian 10-year bond rates - briefly - above 2.0% in late October. In NZ 10-year bond rates rose above 2.6%. At those levels the markets were implying that, in the long term, cash rates in Australia and NZ would settle down at around 2.3% and 2.7% respectively - close to farrelly's worst case scenarios. As outlined earlier, we think those levels of cash rates are not likely because of the high levels of household debt. All of which makes longer term fixed interest reasonable buying right now - the levels may not be attractive but they may be about as good as it gets for a decade or more.

Again and again we see that once risks are well known they should hold little fear for long-term investors. What can really hurt us are unknown unknowns. Obviously, we can't dwell on these because we don't know what they are. All we can do is understand that around every corner a significant risk lies - and that we won't see it coming. Accordingly, take an appropriate level of risk in portfolios, stay well diversified, accept that we will suffer from severe market downturns from time to time and keep our eyes resolutely focussed on the long term.

And, for now, don't worry about inflation.